Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

INTELLECTUAL AMMUNITION

Core Inflation Not as Low as It Looks

Wednesday, November 16, 2005

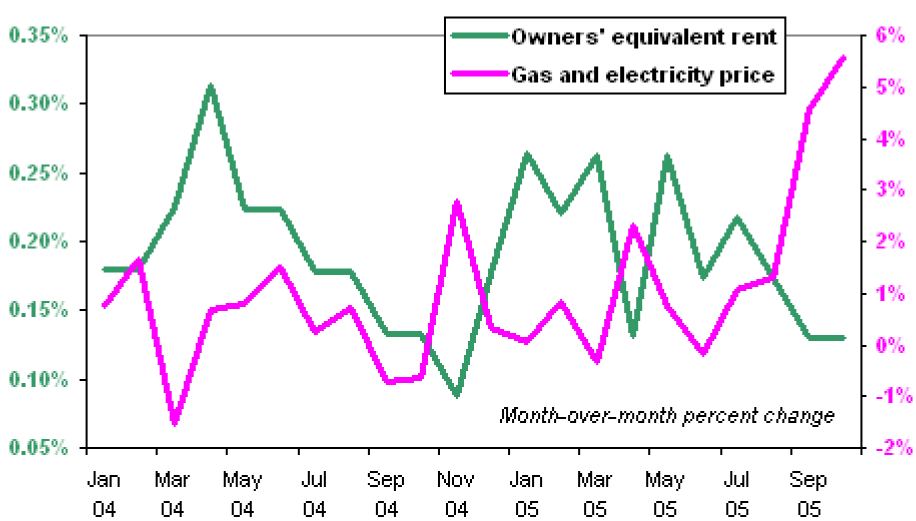
David Gitlitz

Statistical artifacts are holding down reported inflation. Soon those same artifacts will boost it.

Another apparently benign month of **core consumer and producer inflation** has given the **bond market** an excuse to rally and taken a chunk out of expectations for further **Fed** action reflected in the **interest rate futures** market. **June Eurodollar futures** closed Monday pricing a tossup between an **overnight rate** of 4.5% or 4.75% by mid-2006. Today, after the **PPI** and **CPI** releases of the past two days, the June contract is discounting for a **fed funds rate** below 4.5%. Our analysis indicates, however, that the price indexes are providing a false sense of comfort, attributable to distortions that are likely to be reversed in the months ahead.

Yesterday's reported decline of.3% in **core PPI** took the market by surprise, as the consensus forecast was for a modest but positive increase of 0.2% in October **producer prices ex food and energy**. The negative reading was warmly greeted by some as a sign that recent inflation worries have been overdone and that price pressures were now more likely to diminish than to grow. Not so fast. Turns out the reduction in October core producer prices was entirely due to a glitch in the **seasonal adjustment** of **auto prices**. Unadjusted, **passenger car prices** last month increased 2.5%. October, however, is the month that the **Bureau of Labor Statistics** enters **new car models** in the PPI, and based on historical experience, it includes a higher-price assumption for the month in the seasonal adjustment. Because prices didn't rise as much as assumed, on a seasonally adjusted basis car prices were shown falling 3% in the PPI. A BLS staffer confirmed that this seasonal adjustment issue was completely responsible for the reported decline in the index. Without it, the core PPI would have been up 0.2%.

The **core CPI**, rising 0.2% last month and up 2% year-on-year, is beset by more fundamental problems. Fully 23% of the core index is accounted for by **owners' equivalent rent**, a statistical confection that attempts to measure the cost of **housing** by estimating how much **homeowners** would have to pay for rent. This measure has been held down during the **residential real estate boom**, for one thing, because the relatively greater appeal of home purchases has left a glut of **rental**



http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

properties, keeping rents down. While **home prices** nationally are up some 14% in the past year, owners' equivalent rent is up only 2.25%, and rose just .1% in October. Although this has been helping to keep core CPI in check with **mortgage rates** low and the housing market thriving, as rates rise and housing cools, rental prices are likely to recover, leading to a significant bump higher in core CPI.

But the rental price calculation has been even further distorted by the methodology for dealing with rising **energy prices**. To arrive at a core (non-energy) estimate of rental prices, BLS subtracts rising energy costs from its calculation of owner equivalent rents. To the extent, therefore, that energy costs in housing are rising faster than rents, which is likely in the short run, the methodology actually pulls the rental estimate lower. A sense of the process at work can be gleaned from the chart on the previous page, plotting gains in **gas** and **electricity** prices against owners' equivalent rent. Last month, gas and electricity were up 5.6%. With the disproportionate weight of owners' equivalent rent in the index, this has been a significant factor holding down core CPI. In due course, however, higher energy costs are likely to be reflected in rent, and much of this dynamic is likely to reverse.

The **gold** price move today, rising some $10 to just below $480, can be seen as reflecting the **inflationary risk** if the subdued core inflation data is indeed seen by policymakers as a signal that the task of **policy normalization** can be cut short or approached in an even more **"measured"** manner. At this point, however, we assign a fairly low probability to that risk. Although **Ben Bernanke's** confirmation hearing yesterday did not leave a definitive impression regarding his preferred **operating approach** (as opposed to his **policy objective**, which is undoubtedly **price stability**), the remarks of his soon-to-be colleagues leave little doubt that they see the task remaining unfinished. We remain convinced that a moderate bulge in core inflation is all but certain, based on the Fed having maintained an exceptional degree of **policy accommodation** over the last three years. We're also confident, however, that the Fed is committed to remaining on course to ensure that a bulge to 3% or so in core inflation does not become a 5%-plus breakout.

Bottom Line: The latest benign core inflation data is being mistakenly read as an indication that inflationary pressures are falling and the Fed can be less assertive in moving to normalize its policy posture. In fact, the PPI and CPI ex-food and energy measures have been subjected to distortions that are unlikely to be sustained. As these unwind, the core statistical indexes will move higher, probably toward a range around 3% on core CPI. It's important to note, however, that this bulge will reflect the Fed's earlier stance of aggressive monetary ease. On its current course, the Fed appears intent on rooting out these inflationary influences and ensuring that policy is restored to an **equilibrium** stance. TM